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REGULATORY ASPECTS OF CROWDFUNDING PLATFORMS AS AN EMERGING PART OF ALTERNATE FINANCE MARKET IN EUROPE

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Abstract. The article is devoted to the Regulatory changes in crowdfunding market in the EU, associated with introduction of the new Regulation (EU) 2020/1503, applied from November 10, 2021, that introduced uniform and centralized supervision over the crowdfunding platforms, posing new obligations, financial commitments, and challenges for the existing and operating market players, that by introducing this regulation *de facto* have been equated with financial institutions. The paper reveals the marked background and underlying factors, causing the necessity of this regulation; it also outlines, from one hand, the benefits pertaining to transparency and investor protection it introduces, but, from the other hand, the main hurdles the crowdfunding platforms faced, that made ESMA initiate the prolongation of transition period twice, totaling one year. In the conclusion, the author provides it opinion on the prospective changes in the outlook and structure of crowdfunding market and its development potential in new legal environment.

Key words: crowdfunding, crowdfunding platforms, lending-based and equity-based models, Regulation (EU) 2020/1503, RTS, alternate finance, ESMA, EBA, ECSP authorization.

Introduction. Crowdfunding is a relatively new concept in today's world of finance. The ultimate idea of crowdfunding is that a platform as an electronic marketplace brings together persons that possess and have intentions to allocate their free funds as the investors and those who needs funding as the borrowers or business owners. Crowdfunding is also associated with non-business purposes like charity. Such platforms appeared at the turn of the century while 2005 was the year the first crowdlending platform, Zopa, was launched in the UK [1].

The rapid development of alternate financing market was largely due to the fact commercial banks as the conventional source of funding for business, became increasingly precautious after the financial crisis of 2008-2010, including limitations in their credit policy imposed by the mother companies related to mandatory minimum amount of borrower's contribution, excluding from financing non-traditional sectors or business fields where the bank analysts lack expertise, etc.

Never the less, until recent times the banks remained beyond competition in terms of interest rates. Yet in the mid-2022, the banks rates were record-low until, responding to global uncertainty and growing inflation, the ECB unprecedently raise interest rates 10 times in a row within 14 months, from July 2022 to September 2023, leaving refinancing rate record-high at 4.5% (up from 0.0%) [2]. With the forthcoming increase of EURIBOR, from around -0.55% in mid-2022 to 3.89% in the beginning of November 2023 [3], the loan interest rates of commercial banks became much less competitive. For example, in Latvia average interest rate for business loans, offered by commercial banks, increased from 2.2–2.4% in mid-2022 to the record 6.74% as of 01.09.2023 [4]. In these circumstances, the platforms, generally offering interest rates from 9% (for mortgage-backed loans sometimes even lower), became competitive also in terms of the cost of capital, which is privately sourced and not tied to the interbank market.

The absence of a uniform regulation in crowdfunding sector in Europe leaded to the emerging "grey sector", where, in the conditions of low to no transparence, the platforms were able to operate on their own, including, in some extreme cases, placing misleading or purely fake investment offers and/or intended misappropriation of investors' funds which, prior to Regulatory requirements, could be held "in one basket". Albeit called an "investment account", in many cases it as nothing else but another payment account of the platform, technically not segregated from its operating account, which did not prevent free and unlimited money transfers between the accounts. One of notorious cases includes the failure of two platforms in Estonia, Kuetzal and Investio, both founded by entrepreneurs with Latvian origin to fulfil their obligations to investors in early 2020 [5]. National regulation in the field of crowdfunding, where the respective law was adopted (e.g., Lithuania, where crowdfunding law entered into force on 01.12.2016) *de facto* meant the opportunity of the crowdfunding operator to work in legal field within the country and was irrelevant to its possible cross-boarding operations.

The article aims to outline and explain the main benefits brought to the market with the EU Crowdfunding Regulation, including transparency of operations, protection of investors, anti-money laundering and business continuity consideration. From the other hand, it addresses the main problems and challenges the potential and especially operating crowdfunding platforms faced to comply with the new Regulatory requirements. In the conclusion, the author expresses an opinion on how the development prospectives of the emerging crowdfunding market will be affected.

The methods used in the research are: comparative analysis, synthesis, statistical data analysis, review of legal acts and case studies.

Limitations of the research: under "crowdfunding market" and "crowdfunding platforms" in the context of this article we understand only the crowdfunding service providers in the context of Regulation (EU) 2020/1503 [6], i.e., the platforms that provide classic crowdfunding service to business by collecting a pool of investments to be further issued in the form of a loan (lending-based crowdfunding) or invested in equity of a company (equity-based crowdfunding). The research does not cover P2P models, where direct investments without pool financing are made via the platform, including direct investments in consumer loans, and sale of claim rights, when the platform offers the investors to buy a share in a previously issued loans (in Latvia the latter is popular and used by the largest platforms, such as Mintos or Twino). The reason of this exclusion is that these types of platforms are out of the scope of Regulation (EU) 2020/1503 and European crowdfunding service provider (ECSP) license. The other models in most of cases are subject to other legal acts and require another type of license, for example, in Latvia Mintos and Twino model requires the license of investment broker or credit institution.

Basic theoretical and practical provision. The main changes introduced to the European crowdfunding market by the new regulation need to be treated in complex as they are not limited to the provisions of the Regulation (EU) 2020/1503 (EU Crowdfunding Regulation). These have been significantly expanded and detailed by Regulatory Technical Standards (RTS), followed the Regulation, and developed by European Securities and Markets Authority (ESMA) [7] and European Banking Authority (EBA) [8]. Most of them have gained the status of a separate Commission Delegated Regulation, supplementing the EU Crowdfunding Regulation [9]. Both authorities have issued numerous explanations and clarifications regarding the RTS. In addition, as with the EU Crowdfunding Regulation coming into force became equated with financial institutions, many local Regulatory authorities issuing ECSP authorization rely to other documentation, e.g., guidances, of the EBA for banking and credit institutions either as strong recommendations or even mandatory requirements for the ECSP authorization. Also, the previous Regulatory practice and "good practice" of the financial sector in the EU countries differ, thus local Regulators may sometimes supplement the requirements to the ECSP applicants in their country.

The most important and crucial requirements to crowdfunding platform operators according to the EU Crowdfunding Regulation in its extended interpretation, as described before, include the following:

1. *Separation of investors' and borrowers' funds from platform funds.* Those platforms that do not provide payment services themselves (do not hold a license of payment institution) or do not have

ready software available for this purpose, are obliged to contract and use the service of a EU licensed payment institution that provides the respective solution for crowdfunding platforms and obtain the status of its payment agent, requiring an approval of the financial Regulator in the jurisdiction of the payment service provider. All money transfers of platform's clients are made through a licensed payment institution, which opens virtual accounts for both investors and project owners (VIBAN), but the money is physically stored in the sub-accounts of the depository bank (custody bank), to which the crowdfunding service provider itself does not have access. Through the same VIBAN accounts, the loan is also repaid, income tax deductions are made, in cases where the platform investor is an income tax subject. Such a solution for existing platforms requires significant changes in the IT system, integrating it through an API with the system of the payment institution, since the execution of transactions, data transmission, accounting and storage must be synchronized. This provides protection of investors' funds, making them totally unreachable for possible misuse or appropriation for crowdfunding service providers. The contracted payment institution also is responsible for AML/CTF issues in relation to the ECSP's customers.

2. *Risk management.* To obtain the ECSP authorization, the applicants need to have in place a sophisticated system of risk management, including procedures and policies of management of operational and business risks, which is largely comparable to risk management apparatus in banks or payment institutions.

3. *Business continuity*. The ECSP candidates need to present to the Regulator a comprehensive business continuity plan, explicitly describing how the operator company is going to ensure the continuity of its business operations, especially maintenance of its critical functions. It should clearly show the availability of resources, backups in place and evident sequence of actions, the viability of which needs to be confirmed by regular stress-testing.

4. *Independence of critical business functions and three levels of defense.* Albeit not explicitly defined in EU Crowdfunding Regulation, Regulators pay enhanced attention to the applicant's organizational structure, including clear hierarchy and subordination of duties, previous experience, and competence of company's management. The company needs to have sufficient human resources for carrying out its operational duties; for top management position overlapping with presence in other businesses is critically assessed in terms of working hours available for execution of their functions. In most of cases, it is recommended or compulsory to have a separate Management Board and Supervision Board as well as in-house risk management and auditor function that should be independent in their responsibility and decision-making. Personal data of Risk Manager, Internal Auditor, Compliance and Data Protection Officer need to be submitted and approved by the Regulator. A so-called 3-lines of defense mechanism is aimed at maximum protection of shareholders' interests.

5. *Prevention of interest conflict.* To prevent a conflict of interest between platform owners and borrowers, the borrowers cannot be persons related to the ECSP (those holding 20% or more capital shares, as well as platform officials and management related parties).

6. *Prudential safeguards.* ECSPs must ensure compliance with prudential requirements throughout their operation. In simple words, these are the minimum capital requirements, which correspond to the higher of the following amounts: EUR 25,000 or a quarter of the actual budget overheads of the previous year. Compliance with prudential requirements may take one of the following forms (or a combination thereof): (a) Common Equity Tier 1, the detailed composition of which is set up by Articles 26–30 of Regulation (EU) No 575/2013 [10], namely – the sum of the share capital, share premium, retained earnings and reserves after deduction of investments in intangible assets; (b) an insurance policy covering the EU territories where the crowdfunding service provider operates. In practice, there is little to no opportunity to obtain an insurance due to lack of such practice amongst the insurance companies to assess the risks; therefore, the only means of compliance with this requirement is to have the capital in place.

7. *Information and data security.* Enhanced requirements to the security of crowdfunding platform's IT system, the protection of data within the system and investors' data are in place, inter alia, in the view of prospective Digital Operation Resilience Act, which will come into force in January 2025 and which the crowdfunding platform will be subject to. A separate requirement is 2-factor authorization for platform users. This requirement follows from the spirit of the law, as it stems from the standards set by the EU Second Payment Services Directive (PSD2) [11], which requires stricter authentication requirements for online payments. ECSPs do not provide online payment services, however, when implementing the EU Crowdfunding Regulation requirements, the IT system becomes integrated with the payment service provider's IT environment. Therefore, to ensure the security of payments, crowdfunding service providers should implement an additional authorization mechanism when the user logs in to the platform, that is, not just by entering the username and password, but also, for example, a code that the special subscription service sends to the user's phone number.

8. *Information disclosure about the project and the borrower.* The EU Crowdfunding Regulation obliges ECSPs to prepare and provide information about the investment offer, including the project and project owner (borrower) in a certain format, by filling in and downloading the so-called KIIS (Key Investor Information Sheet). The borrowers must obtain a LEI (Legal Entity Identifier in financial markets).

9. *Credit procedure and project scoring.* Despite the platform operator does not carry out financial responsibility towards the investors if the project fails, it is responsible for duly assessment of the investment offers prior to placement on the platform to minimize risks. The Regulator introduces the requirement to formalize and describe in details the process of assessment of the project and the borrower, including a scoring procedure that is mandatory. It should be disclosed to the investors, including the mechanism of determination of the price of the investment offer – the interest rate offered to the investors for participation in the loan. The loan portfolio quality needs to be monitored thought the lifetime of the loan, including re-assessment of the loan and the collateral, if applicable.

10. *Loan principal limitation.* Regardless of the specifics of the project, the maximum amount for a loan issued to one borrower or a group of related persons for one project from the funds collected on the platform may not exceed 5 million EUR within 12 months.

11. *Detailed requirements to the categorization of investors and enhanced protection of non-sophisticated investors.* All investors are considered non-sophisticated until the investor is granted the status of a sophisticated investor. It is assigned automatically to those compliant with certain criteria specified in the EU Crowdfunding Regulation or holding a professional investor status according to MiFID 2 [12] while the others to get this status they need to pass a knowledge test in the form of a questionnaire, to be approved by the Regulator. For non-sophisticated investors, the platform is obliged to provide: (a) a) simulation of the ability to bear losses – an automated calculation tool for calculation of of loss of 10% of the value of the investor's net assets; (b) a so-called reflection period, i.e., the ability to recall the investment within 4 calendar days.

12. *Reporting obligations.* must provide annual reports to the Regulator according to a certain form, provided for in RTS, which must include, *inter alia*, anonymized information on collected funding amounts, project sectors, investor countries their categories and number. Information on default rates, or the proportion of defaulted loans for at least the previous 36 months must also be provided.

13. *Cross-border passporting.* To be able to provide crowdfunding services outside the country of ECSP registration, a so-called EU passport must be issued. The crowdfunding service provider needs to notify the Regulator that issued the authorization, providing a list of the Member States in which the it would like to provide the crowdfunding services. The Regulator then communicates the information to the host Member State authority and ESMA, which keeps a register of crowdfunding service providers in which the notification is noted.

Overall, the requirements introduced by the EU Crowdfunding Regulation and other related regulatory documents are aimed at transparency, uniform supervision, investor protection and anti-money laundering at the same time. In author's opinion, the introduction of such regulation was absolutely necessary and inevitable, taking into account that alternate finance market emerged dramatically and becomes increasingly competing with traditional financing, which is highly regulated (in case of banks), licensed in most of cases and supervised by local consumer protection authorities (in case of consumer lending) and selectively licensed depending on a Member State (in case of non-bank business loans), but in the latter situation consumers are not involved as participants of the transaction.

There is a large spread of statistical data concerning European crowdfunding market if we compare different sources, but the author finds reliable the data of Cambridge Judge School, which are presented in the 2nd Global Alternative Finance Market Benchmarking Report and reflected in Figure below. Albeit being a little outdated, these data are based on real company-level observations and, in the absence of official market common statistical data, based on submission of mandatory reports by market players, are close to the most precise.

From 2013 to 2019, the European online alternative finance market volumes grew consistently from just $0.4 billion in 2013 to $12.2 billion in 2019. However, in 2020 the survey reported a drop to $9.9 billion, representing the first decrease in market volume since 2013. The authors of the report emphasize that the main reason of this decline was not related to consequences of Covid-19 or overall economic situation, but rather to the decreased number of participants of survey. The analysis of was based on 631 company-level observations in 2019 and 654 observations in 2020, while 117 platforms that did not repeat participation but remained in operation in 2019 and 2020.

The information on the number of participants of the research given in the reports gives an interesting insight on the possible number of crowdfunding platforms, which are the subject of the EU Crowdfunding Regulation. The total number of crowdfunding platforms in Europe, revealed by the authors of this research, including contributing participants and those who rejected their participation, in 2020 was 671. Crowdfunding models described in the aforementioned report and the list of participants of the research enables to conclude that in the context of the research the term "crowd-

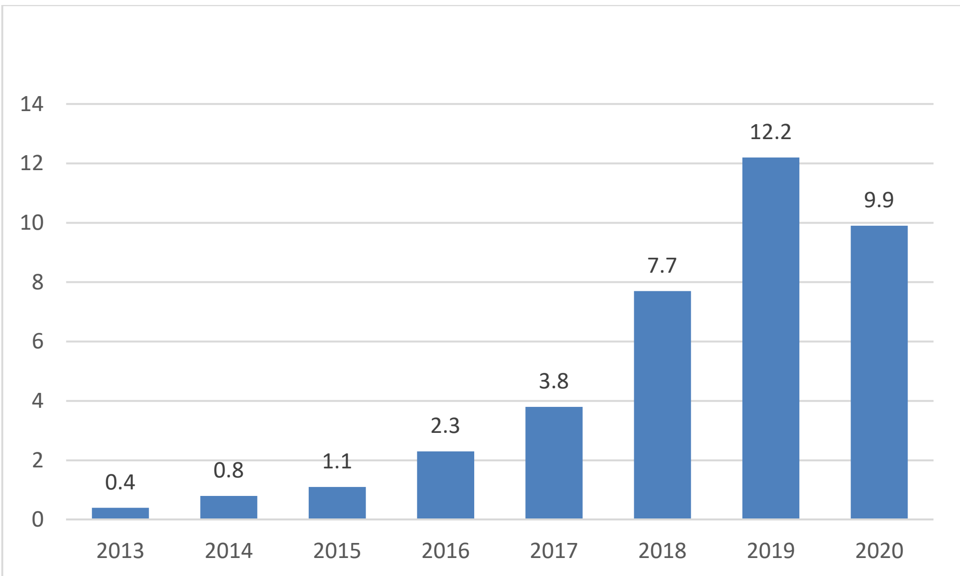

Fig. 1. European Online Alternative Finance Market Volumes 2013-2020, billions USD (Excluding UK)

Source: The 2nd Global Alternative Finance Market Benchmarking Report [13] funding platforms" was applicable both to classic (pool-collection-based) crowdfunding for business purposes which is the subject of the EU Crowdfunding Regulation, and P2P crowdfunding, or direct online loans, which is not. Unfortunately, it is not possible to provide exact figures on the number of platforms which are subject to EU Crowdfunding Regulation, but it can be assumed that these are at least one-half, but, averaging estimation data from different sources as of mid-2023, the author assumes this number around 450. These platforms, not counting new ones, are potential candidates for ECSP authorization.

However, if we compare this number with the number of issued authorizations, published by ESMA on its web-site [14], which on 05.11.2023 was 75, it can be concluded that less than 20% of total estimated number of crowdfunding platforms, subject to the EU Crowdfunding Regulation, obtained authorizations. It can be added that in Latvia two crowdfunding platforms obtained ECSP authorizations from local Regulator, first from former Financial and Capital Market Commission and second from the Bank of Latvia. Interestingly, these platforms, CrowdedHero and Capitalia, represent two different types of crowdfunding: equity-based and lending-based, respectively. The second platform was created as a diversification of operations of non-bank lending institution while the first one is created "from scratch".

On November 10, 2023, the final transition period, initially assumed by the Regulation, entered into force on November 10, 2021, for one year and prolonged twice, for 6+6 months, by the initiative of ESMA, eventually expires and all platforms which are subject to the EU Crowdfunding Regulation and not obtained their license from local Regulator, will be forced to cease or suspend operations.

In author's opinion, the main reason for the repeated prolongation of the term was the complexity of the EU Crowdfunding Regulation and related documents, which was totally new not only to the market participants, but also to their Regulators. RTS, followed the Regulation, experienced several amendments until final editions and the Regulators requested additional documents or significant corrections in already submitted documents from the applicants. But possibly the main challenge and the most expensive, time- and resource-consuming upgrade for the existing and operating platform was the introduction of a VIBAN-based payment solution. To implement this, the platforms needed to develop or order a completely new software and to handle the payments in operation, including servicing the previously issued loans and integrating the flow of payments into the new system.

For investors, the author sees only benefits, except for a more complicated registration process, as the new Regulation provides a completely different level of protection, taking at least absolute segregation and safekeeping of their funds, but also providing more information and transparency.

Easy and transparent Europe-wide provision of services by passporting is another decisive advantage of the EU Crowdfunding Regulation, both for the investors and service providers.

As regards the possible future development outlook, the author believes that, despite the reduction of the number of operating crowdfunding service providers, the total volumes of the market will not decrease, as due to a lower competition the remaining market players will be capable for intensive growth by providing technically advanced solutions, better quality of offers and higher protection of investors that will lead to a growth of trust from the side of investors from one side and increasing interest from the side of the borrowers in the conditions of increasing growth of capital and existing limitations to obtain a loan in traditional markets.

Conclusions. The adoption of the EU Crowdfunding Regulation was an inevitable and ambitious step forward in the field of organizing the emerging alternate finance market, ensuring unified supervision, and protecting consumer rights. In the author's opinion, this will contribute to the development of the market by increasing transaction transparency and investor confidence. In time, it may turn into an even more significant competitor in the lending market of banking services.

Each new legal act has its own shortcomings, including gaps in the law, which are gradually filled by amendments and supplementing regulations, accumulation of market practice, and there is a great potential to start creating good practices, establish associations, platforms to cooperate with local Regulators. Exclusion of non-compliant market players will free space for steady growth and promoting the development of crowdfunding services market in a new quality, and its sustainability.

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